Strategic Advisory Group
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Roth IRA Conversion

Introduction

While pundits keep busy discussing the status of the estate tax repeal in 2010, a less discussed yet potentially significant estate planning opportunity also exists – the Roth IRA Conversion. Beginning January 1, 2010, all individuals, regardless of income levels, will have the ability to convert existing retirement accounts such as Traditional IRAs into Roth IRAs. Until this year, Roth conversions were available only to those individuals with taxable incomes of $100,000 or less.

Traditional IRAs differ from Roth IRAs in two very important ways. First, Traditional IRAs impose mandatory withdrawals beginning at age 70½. Second, withdrawals are taxed as ordinary income. By contrast, Roth IRAs have no mandatory distributions for IRA owners or their spouses. Those who inherit a Roth IRA must take withdrawals over their lifetimes, but all withdrawals are tax-free provided they do not occur within five years of conversion.

Conversion triggers ordinary income tax on the amount converted in the year of conversion (although a special opportunity exists for those who convert in 2010 to spread the tax liability over two years). Paying tax now instead of later goes against the grain of conventional tax planning, but the extended tax-free compounding afforded by conversion and the absence of taxes upon withdrawal should outweigh the short-term cost. Pre-paying the income taxes of the ultimate beneficiary is also good estate planning, assuming we will have an estate tax. By contrast, paying estate taxes on a Traditional IRA – withdrawals from which will be taxed to children or grandchildren – is a less efficient transfer of wealth.

Who should consider converting?

Although the benefits can be considerable, Roth conversion does not make sense for everyone. Conversion makes little sense for those who have directed their IRAs to go to charity. Moreover, the benefits of conversion take a long time to accrue. Thus, we think Roth conversion is most attractive in the context of planning for one's children and grandchildren.

If you do *not* plan to direct your IRA to charity, here are a few questions to answer:

- Is wealth transfer to future generations an important priority?
- Can you afford to pay the tax on conversion without withdrawing from the IRA now or in the future?
- Will your estate be able to pay any estate taxes without withdrawing money from the IRA?

If your answers to these questions are yes, you should consider at least a partial conversion in 2010. If your income tax rate in 2010 will be much lower than in future years (example: aging carryovers for either charitable deductions or business losses), then conversion this year can be especially compelling.

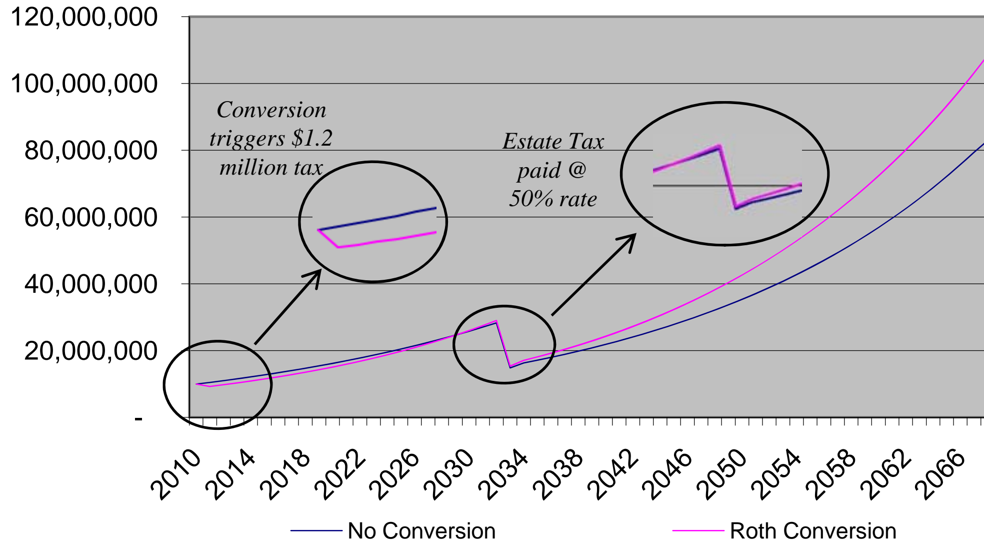
Estate planning scenario

Imagine the scenario of Isabel and Ron Arnold, both age 70, with four children: Ronald, Jr., Olivia, Tom and Henry, and six grandchildren. Isabel and Ron successfully operated and then sold a family business, resulting in personal investment portfolios of $7 million and Traditional IRAs of $3 million. The Arnolds want to pass as much wealth as possible to their children and grandchildren. Since they believe their personal assets (*i.e.*, their non-retirement assets) can support their lifestyle needs and pay for the taxes due from an IRA conversion and any estate taxes, converting their IRAs probably will increase their legacy.

In our model (Chart 1), we have considered two scenarios for the Arnolds: one where they convert 100% of their retirement assets in 2010 and pay the taxes due from their personal portfolios, and the other where they maintain their current structure. Chart 1 measures the value of the initial $10 million combined portfolio over two generations. (The large dip in 2033 represents the estate taxes paid upon the death of the surviving spouse. We have assumed a 50% combined Federal and State estate tax rate for the sake of this illustration.) While our model shows the conversion scenario "catching up" during Isabel and Ron's lifetimes, the Roth IRA conversion benefit really begins to grow in the years after their deaths. This happens because after the income and estate taxes are paid with non-retirement assets, a much larger proportion of the family's wealth is compounding tax-free under the Roth conversion scenario.

As Chart 1 suggests, a Roth IRA has the potential to grow very large over time, with a significant proportion of the family wealth captured within the IRA. Accordingly, the Arnolds should consider their IRA beneficiary designations as part of their overall estate plan. It may be more prudent for the Arnolds to designate trusts for their children than to designate the children themselves and give them unfettered access to the Roth IRA assets.

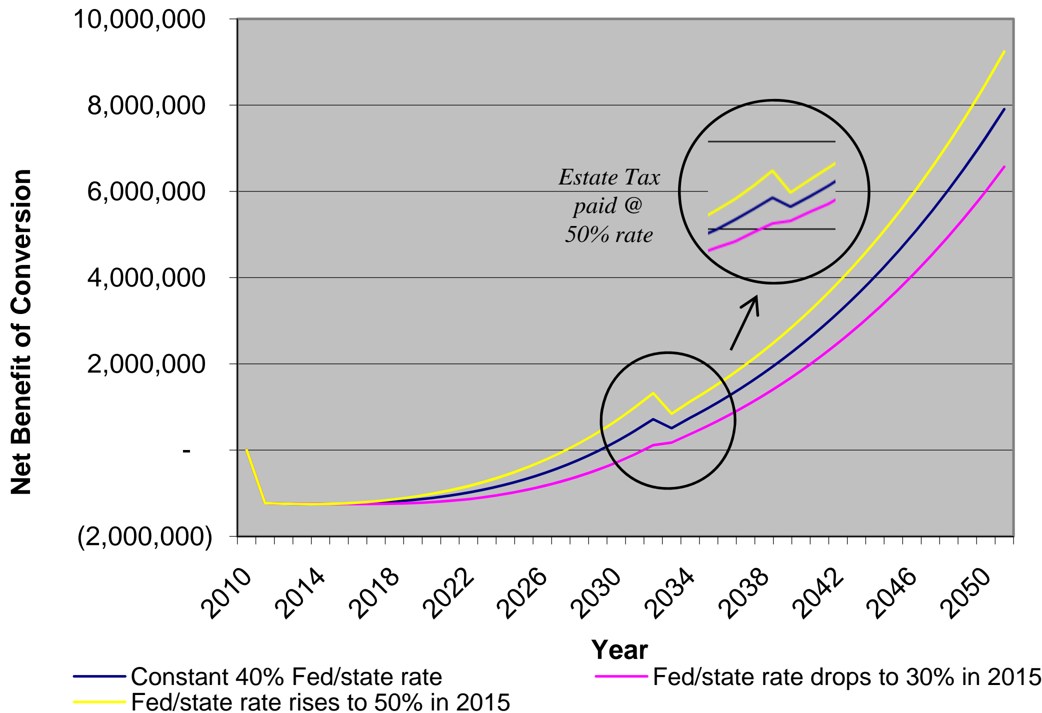
Chart 1



What if income tax rates decrease?

Looking at the growing Federal debt and deficits, it is hard to imagine that taxes will be lower in the foreseeable future. However, it is a scenario worth exploring when making such a long-term decision. Chart 2 plots the Arnolds' net benefit from conversion over time. Due to the tax on conversion, the net benefit starts out negative under all three scenarios for future income tax rates. (If the Traditional IRA's imbedded tax liability is included in the net benefit calculation, the net benefit can be shown as neutral instead of negative at the beginning.) A 10% drop in tax rates would reduce the benefit of conversion but conversion still increases the family's wealth over the long term. Conversely, if we assume taxes increase from today's rates, conversion becomes even more attractive.

Chart 2



What advice would we give for the Arnold children who have retirement assets of their own?

If a conversion (in part or in whole) is right for Isabel and Ron, should their children be converting their retirement accounts for their own benefit or the benefit of their children and grandchildren? The threshold issues are once again charitable intentions for IRA assets and the ability to pay the tax without withdrawing from the IRA.

The Arnold's youngest child, Henry, is 40 and has accumulated a nice nest egg in both retirement and taxable savings. Henry likely has 30 years before needing to call on his retirement assets, and he does not currently plan to leave a charitable bequest. He also has enough in personal savings to pay the tax on a Roth conversion. Accordingly, a Roth conversion appears to make sense for Henry, but the risk of the unexpected is greater for Henry than for his parents. Given his relative youth, a lot can change for Henry between now and his retirement. He may eventually decide to make a charitable bequest. Moreover, a conversion tax that appears affordable now may seem costly in retrospect if he suffers a loss of income in the coming years.

Strategic timing

For those who have decided to convert, we recommend that conversion be made early in 2010. (Residents of Wisconsin, however, should wait until the state tax consequences of conversion are resolved.) Until tax returns for 2010 are filed (typically April 15, 2011 or October 15, 2011 with an extension), a Roth converted in 2010 can be re-characterized back to its original form, thereby eliminating the tax. Converting early in 2010 affords the opportunity to establish the tax liability and wait as long as 22 months before making the conversion irrevocable. If the Roth IRA suffers a material loss of value during that time, it may make sense to reverse the conversion. Splitting an IRA into multiple IRAs prior to conversion and investing each differently can add an interesting wrinkle to this ability to "un-convert." Those IRAs that grow could be left as Roths, and those that lose value might be re-characterized.

Going forward with a Roth IRA

Although the law provides unlimited eligibility to convert an IRA in 2010, the income limitation (currently $105,000 for an individual and about $170,000 for married couples filing jointly) continues to apply for annual contributions to a Roth IRA. Accordingly, many who convert in 2010 will not be able to make contributions to their Roth IRA in 2010 or thereafter. Such individuals may have the option of contributing to a separate Traditional IRA. Unlike contributions to a Roth IRA, contributions to a Traditional IRA may be tax-deductible. Limitations on contributions to a Traditional IRA (and deductibility) vary according to circumstance, but generally individuals under 50 years of age can contribute annually the lesser of $5,000 or their earned income; for those age 50 or older the limit is the lesser of $6,000 or their earned income. Taxpayers with income from self-employment may qualify to make larger contributions.

Conclusion

A Roth conversion in 2010 can be a meaningful wealth transfer strategy if one has the ability to pay the conversion tax from personal assets. Even if tax rates decline or the ultimate beneficiaries are in a lower tax bracket when funds are distributed, the family still wins if given the benefit of time by allowing investments to compound in a tax-free environment. Conversion also looks beneficial for younger taxpayers who can afford to pay the tax, but the risk of the unexpected is higher for them.

While our modeling of scenarios makes Roth conversion look quite attractive, we must acknowledge that the future is unknowable. Although it seems unlikely, Congress could pass laws in the future that reduce or eliminate the benefits of a Roth conversion. Thus, the only certainty is that conversion will result in a tax to be paid now. As investors, we know that future results are never guaranteed. We view Roth conversion as an attractive investment for certain individuals, but the amount of conversion (and amount of tax to be paid) should be carefully considered in light of each client's circumstances.

We recommend that you consult your tax and investment advisors to determine whether the Roth IRA conversion strategy is right for you. We encourage you to speak to your team at Brown Advisory to discuss this important decision.

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